



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
HAROLD R. JACOBUS)

Appearances:

For Appellant: Burton Fleischer
 Bookkeeper

For Respondent: Charlotte A. Meisel
Counsel

Q P _ I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Harold R. **Jacobus** against a proposed assessment of additional personal income tax and penalties in the total amount of **\$4,081.58** for the year 1976 and against a proposed assessment of additional personal income tax in the amount of **\$2,035.88** for the year 1977.

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The question presented is whether appellant has established any error in **respondent's** determination as modified.

Appellant failed to 'file a timely personal income 'tax return for 1976. When appellant failed to answer its requests to file such **return**, respondent estimated appellant's income for that year and issued a proposed assessment together with a 50-percent penalty for failure to file and for failure to file upon demand. On April 5, 1978, respondent received appellant's 1976 return and, soon thereafter, his timely filed 1977 return.

Upon audit of those **years**, respondent apparently adjusted its initial assessment^{1/} for 1976, but determining^{2/} that several deductions claimed as business expenses^{3/} on each return should be disallowed and that income of \$12,500 from the sale of a Caterpillar loader (hereinafter "loader") had not been reported in 1976. In addition, respondent determined that the amount of gain from the sale of appellant's office building had not been properly reported, **However**, after several meetings, respondent conceded that appellant had substantiated the bulk of the interest expenses claimed, that the loader had a basis of \$8,500, reducing the amount of unreported gain to \$4,000, and that the gain on the sale of appellant's office building had been properly reported. **Accordingly, respondent's** concessions left the following items at issue: (1) for 1976, unreported income of \$4,000 resulting from the sale of the loader (sales price of \$12,500 less basis of \$8,500); (2) for 1977, interest expense^{3/} of \$29; and (3) for 1977, legal expenses of **\$8,200.**

The first issue for our consideration is the proper **amount**, if **any**, to be included **in** appellant's **1976**

1/ Respondent also waived the penalties which it had Initially assessed.

2/ The deductions which respondent disallowed at **that time** were interest expenses of \$12,132 for 1976 and \$1,092 for 1977, and legal expenses of \$8,200 for 1977.

3/ Appellant has chosen not to contest **respondent's determination** with respect to the disallowance of \$29 of

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income as a result of the sale of a loader for \$12,500.' Appellant acknowledges that he sold the loader for \$12,500, but contends that his basis in the loader was also \$12,500 so that no gain was realized upon such sale. Briefly, appellant **contends that** he received the loader in exchange for his undivided one-half interest in certain real property. Appellant contends that his cost basis in the real property (which was raw land) was \$9,250 and that such basis was increased by improvements he made to that land during his ownership which resulted in a total basis of approximately \$12,500. When he exchanged that land for the loader in 1976, appellant contends that his basis in the loader equaled his basis in the land. Respondent, on the other hand, contends that appellant's basis in the loader was limited to \$8,500, which was what the previous owner of the loader had paid for that loader. Based upon the record before **us**, we hold that appellant has proven no error in respondent's determination with respect to the sale of his loader.

Assuming, **arguendo**, that appellant's basis in the loader should be the same as that of the subject real property for which it was exchanged, we find that appellant has not established that his basis in the real property was, in fact, \$12,500. Indeed, based upon the terms of purchase of the said real property, the deed of trust indicates that appellant's cost basis was \$8,800 and not \$9,250 as he claimed. **Moreover, appellant has submitted no evidence which would establish that the** basis of the real property was increased by capital improvements over the term of his ownership. Since it is well settled that respondent's determinations of tax are

3/ (continued)

interest expense claimed in 1977. Accordingly, this issue will not be discussed here. Appellant does contend however, that a fourth issue exists with respect to the actual computation of tax due. In brief, appellant contends that even if he should lose this appeal, respondent has levied more from his checking and savings accounts than is now at issue. Respondent's October 4, 1983, letter addressed to Leone Arnold Brown, appellant's former bookkeeper, appears to acknowledge this fact and notes that additional reductions of the assessments will be made when this matter is concluded. Accordingly, based on the record before us, no real controversy with respect to the tax computations appears to exist and this "issue" also will not be discussed further.

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presumed correct and that the taxpayer has the burden of proving them erroneous (Appeal of Ronald W. Matheson, Cal. St. Bd. of Equal., Feb. 6, 1980), we find that appellant has not-proven **respondent's** determination of his basis in the loader and, consequently, his tax to be erroneous. Moreover, the foundation of appellant's contention that the basis of the loader should equal his basis in the real property appears to be that a tax-free exchange occurred pursuant to the provisions of Revenue **and Taxation** Code section **18081** upon the subject exchange of his real property for the loader. However, section 18081 applies only to exchanges of "like kind" property. Here, real property was exchanged for personal property which is clearly not an exchange of "like kind" property. (Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941).) Accordingly, without the safe harbor provisions of section 18081, upon the exchange of the loader for the real property, gain or **loss**^{4/} would be recognized as if a routine sale had **occurred.** **Moreover,** the basis of the loader would be its fair market value (**presumably** what the previous owner had paid for it or \$8,500) and its holding period would begin from the date of the exchange. Accordingly, respondent's action, as modified by its *concession*, must be sustained.

The second issue for our review is whether appellant is entitled to deduct legal fees of \$8,200 as an ordinary and necessary business expense deduction **pursuant** to Revenue and Taxation Code section 17202 in 1977. Pursuant to a written agreement dated April 25, 1975, appellant transferred certain real property to his attorney "as security for payment of accrued fees **or fees** to accrue in the future. ..." (Resp. Supp. Memo., Exh. 8.) (Emphasis added.) At that time, the parties agreed that the real property given as security had a value of \$11,000 and that, based upon such value, appellant "had a credit balance of \$8,500, against which future fees and costs will be charged." (Resp. Supp. Memo., Exh. 8.) The subject real property was held by appellant's attorney as security until January of 1973, when a second agreement was reached in which appellant, apparently, transferred such real property in fee simple to **his** attorney in satisfaction of all of his accounts except one. As indicated above, in 1977 appellant deducted \$8,208 for such legal fees. Respondent disallowed such deduction contending that such expense had not been substantiated

^{4/} The amount of that gain or loss **or its** character is not now before this board.

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nor shown to have been incurred for a business purpose. Based upon the record before us, we must sustain respondent's action:

It is, of course, well settled that respondent's determination to disallow a deduction is presumed correct and the burden of proof is upon the taxpayer to establish his entitlement to it. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Appeal of Robert V. Erilane, Cal. St. Bd. of Equal., Nov. 12, 1974.) Moreover, the fact that it may be difficult, if not impossible, for the taxpayer to substantiate any claimed deduction does not relieve him of his burden. (Appeal of Arthur, Jr. and Daisy M. Bedford, Cal. St. Bd. of Equal., June 29, 1982.)

When property is transferred in order to pay a deductible expense, a deduction may be allowed for the fair market value of the property at the time of transfer.^{5/} (Appeal of Edmund L. Carboneau, Cal. St. Bd. of Equal., Sept. 30, 1980.) Appellant has provided no evidence that the transfer of real-estate in satisfaction of his legal expenses occurred in 1977. Indeed, the record appears to establish that the transfer took place in 1979 and not 1977. Moreover, the record indicates that appellant had several lawsuits in progress during 1977, some of which, such as suits involving a divorce and personal medical fees, were clearly personal in nature. Therefore, the expenses incurred in prosecuting those lawsuits were not deductible. (Appeal of Curtis H. Lee, Cal. St. Bd. of Equal., July 26, 1978.) Based upon the record before us, we are unable to find that the legal services provided in 1977 were, in fact, paid for in 1977 or that they were provided for a business purpose, as opposed to personal purposes. Accordingly, respondent's disallowance of this deduction must be sustained.

For the reasons set out above, respondent's action, as modified by its **concessions**, must be sustained.

^{5/} The settlement of an obligation with property is usually treated as a taxable disposition of the property for the amount of the obligation satisfied through the transfer. (Carlisle Packing Co., 29 B.T.A. 514 (1933).) Accordingly, even if appellant were able to substantiate that the transfer took place in 1977 and that the legal fees were incurred for a business purpose, he would have to recognize taxable gain upon the transfer of the real property in satisfaction of his obligation for attorney fees.

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O R D E R

Pursuant to the views expressed in the **opinion** of the board on file in this proceeding, and **good cause** appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND **DECREED**, pursuant to section 18595 of **the** Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Harold R. **Jacobus** against a proposed. assessment of additional personal, income tax and penalties in the total amount of **\$4,081.58** for the year **1976**, and against a proposed assessment of additional personal income tax in the amount of **\$2,035.88** for the **year 1977**, be and the same is hereby modified in accordance with respondent's concessions. In all other respects, the action of the Franchise Tax Board is **sustained**.

Done at Sacramento, California, this **8th** day Of January , 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett, Mr. Nevins and Mr. Harvey present.

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| <u>Ernest J. Dronenburg, Jr.</u> | , Chairman |
| <u>Conway H. Collis</u> | , Member |
| <u>William M. Bennett</u> | , Member |
| <u>Richard Nevins</u> | , Member |
| <u>Walter Harvey*</u> | , Member |

*'For Kenneth Cory, per Government Code **section 7.9**